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**Volume 2 Selected Papers**

# Objectives of Financial Statements

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## **Accounting Income and Economic Income**

*George H. Sorter*

### **Economic Income**

There is general agreement among economists who have written on this subject that income is to be regarded as a measure of the change in "well-being" or "better-offness" occurring in some specific time period irrespective of whether it is measured statically or dynamically and regardless of the measurement bases used.

A change in well-being can result through either immediate satisfaction or increased prospects for future satisfaction. Thus, income has often been defined as consumption plus investment. Consumption corresponds to immediate satisfaction, whereas investment is identified as the postponement of present consumption with increased future consumption or satisfaction as one of its goals.

### **Economic Income for Individuals**

Much of the controversy in defining income for individuals is based on the fact that either current or prospective satisfaction is necessarily subjective and based on individual preferences and the utility assessments of different individuals. A person's satisfaction or consumption may, to a large extent, be nonmonetary. Thus, one person may derive income in the form of personal satisfaction from viewing a painting, whereas another person may not.

The same problem exists in defining investments of individuals. For some persons the ownership of art objects may be an investment over and above their monetary values. For others it may not, and so forth.

### **Economic Income for Business Entities**

These definitional problems are not as acute for business entities. Such organizations (as opposed to individuals who may own the business) should not have utility functions. Their well-being is generally restricted to, and measured by, monetary benefits.

In the case of business entities, consumption is defined strictly as dividends; net investment is defined simply as the change in the value of the firm

itself (exclusive of any additional explicit stockholder investments in the firm).<sup>1</sup>

Economic income for a firm is generally defined as the change in the value of the firm plus any dividends paid during the period. Almost unanimous agreement exists among economists that the value of an asset is quantified by the discounted value of the future cash flows attributable to the asset. The value of a firm, which is an asset itself, is also considered to be quantified by the discounted value of the future cash flows attributable to it.

Should the measurement of economic income, or alternatively, an accounting income that corresponds more closely to economic income, be the objective of accounting? A negative response to this question is appropriate for reasons discussed in the next section of this paper.

### **Economic Income and the Accountant**

Users of financial statements would like to know the cash proceeds that they will receive from investments that they make. In terms of equity securities these cash proceeds are measured by the dividends that the stockholder will receive and the market price at which he will be able to sell his shares, that is, his share of the economic income of the firm. This information, however, cannot be supplied by the accountant, at least not presently.

Even in a world of relative certainty where the probabilities of all prospective events affecting a corporation are known, the accountant still could not measure the prospective market values of a firm or its economic income. The price an individual is willing to pay or receive for a security is determined by (1) his expectation concerning future events, and (2) his personal preferences relating to these events. Individuals generally will be willing to pay less for a security which has a 50 per cent probability of returning \$100 and a 50 per cent probability of returning 0 than for a security which has a 100 per cent probability of returning \$50. Thus, most individuals are risk averse but they are risk averse in differing degrees. The extent to which an individual is risk averse will determine how much less he is willing to pay for the security with a 50 per cent probability of returning \$100 and a 50 per cent probability of returning 0. Individuals with different risk preferences will therefore be willing to pay different amounts for securities whose returns are subject to equivalent uncertainties.

The market price of securities reflects a collective consensus of many investors and incorporates their collective risk preferences. Therefore, the accountant, in order to measure prospective market values and economic income, would not only have to know the probability of future events occurring

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Many problems of defining income, of course, remain. This definition of income as consumption plus investment can easily be used to analyze such problems as whether the measure of income should reflect deduction for imputed interest on stockholder investment and whether unexpected gains should properly be included in income. Analysis of these problems is not carried further in this paper, however.

but also the collective taste and preferences of investors. In actual fact, of course, he knows neither, and thus the accountant cannot prospectively communicate future market values of a company's shares.

Financial statements can communicate the market value of these shares and the economic income of firms once these have been determined by the market, but this information is adequately communicated through other means, such as the financial press.

It does not seem useful for accountants to describe market values of a firm's securities after the fact. But even if financial statements cannot measure in a prospective sense the market value of a firm's securities, it may be argued that the value of a firm can be described apart from the value of the securities of the firm. However, such an abstract or intrinsic value of a firm apart from the value of the securities does not exist. Value in each and every case represents an assessment by someone. Value as an abstract principle is meaningless. The value of a firm as a whole exists only as it is perceived by others. Value in terms of a dictionary definition of "the relative worth, merit, or importance" or as a useful construct in economics is always relative. Value does not exist in a vacuum; it must always be viewed as value in relation to someone or to some purpose. The "relative worth, merit, or importance" of an object must be defined in terms of the utility of that object in fulfilling goals or desires of individuals. A firm may have value in relation to its stockholders and/or in relation to its managers and/or in relation to its employees. It cannot have value in and of itself apart from these interests. Thus, since the notion of "abstract value" has no meaning, it clearly cannot and should not be measured by accountants.

Even though there is no abstract value of a firm that can be measured by accountants, there are values of individual assets of a firm which may be measured. Aggregation of these asset values may be said to define the value of the firm.

Certainly individual assets of a firm have value, and insofar as these values are known in the market—because of quotations or transactions—these market values could be communicated in financial statements. However, the market value of individual assets of a firm is determined by the utility of those assets as judged by many users with many intended uses. The particular use for which a firm owns an asset is only one of many determinants of value. For example, the market value of an asset will be nil if it is so unique or specific that it can be used only by the firm holding it. No one else will demand the asset if it is of no use to them. Such an asset, however, can have significant value to the firm that owns and is able to use it. Perhaps the best illustration of this point relates to an automobile. It has often been said that an automobile loses one-fourth of its value when it is driven out of the showroom. Such a statement is both true and meaningful, as well as fallacious. If the intended use of an automobile is its sale, then the value of that automobile is in fact reduced when ownership passes from dealer to customer. The dealer generally possesses a comparative economic advantage not enjoyed by the customer, and thus the car is more valuable if sold by the dealer than by the customer. If the intended use of the car, however,

relates to its transportation services, then it is fallacious to say that the value has decreased when the car is driven out of the showroom or when ownership passes from dealer to customer.

Market values of individual assets do not always relate directly to their value to the firm holding them. Further, the use value of individual assets of a firm depends to a great degree on their joint use with other assets, and it is difficult to separate value of individual assets from a value of the firm. While market values of individual assets may indeed provide useful information for users of financial statements, the recording of values of individual assets should not be thought of as a fundamental objective of financial statements.

Therefore, income as defined in terms of changes in the market value of individual assets is also not particularly relevant in terms of a specific firm. Income so defined does not measure the progress or attainments of a firm in relation to some specific goal. In fact, it may be argued that a firm cannot have income. If income is indeed a measure of better-offness, can a firm be better-off apart and distinct from the better-offness of stockholders, managers, or employees? People may be better-off but a firm, a fictional entity, cannot be better-off and thus does not have income. In our view, value should always be defined in relation to an individual's goal and not abstractly. Income also should not be defined in the abstract since it relates to the satisfaction of individual goals.

The concept of economic value involves limitations which render it futile, both in terms of implementation and general acceptance, in the context of accounting objectives. Consensus about economic value is properly the function of the market, not accounting. Information provided by the accounting process should be unambiguously characterized and communicated as an *input* to evaluation models; it should give no pretense of being the ultimate *output* or result of evaluation models.

Accounting information of all types, including income statements, balance sheets, funds statements, statements of cash receipts and disbursements, etc., has an important role to play in allowing different users with different tastes, different assumptions, different decision criteria, and especially different risk preferences to evaluate and predict the future cash consequences of the firm. Accountants have long been aware of this and have provided disaggregated information about such items as sales, cost of goods sold and different expenses. Accountants have tried to quantify different assets and liabilities and have provided a funds statement. Had accountants alternatively assumed that their only function was to communicate income and value, this could have been accomplished through a simple process of aggregation. That is, the various operations and events of an entity could have been reported in aggregated form, and only single numbers such as income and value would have been disclosed.

If accounting should provide information useful for prediction, evaluation, and control of certain key variables, rather than reporting the variables or estimates of the variables themselves the following question becomes paramount: Should the objectives of accounting be stated such that account-

ing information facilitates the prediction, evaluation, and control of cash flows rather than the prediction, evaluation, and control of income? As stated earlier, the notion of income means different things to different people who possess different risk preferences. If the objectives of accounting are stated in terms of income, disagreements concerning proper implementation of accounting may arise due to different and diverse definitions of income. Individual A may argue for method X based on his definition of income, and individual B may argue against method X based on his different definition of income. Thus the argument and analysis concern not method X but the desired and different definition of income. Using the concept of cash flows, which is unambiguous and less abstract, this problem of definition is avoided. Disagreement can and probably will continue to exist, but such disagreement will not revolve around the many ambiguities which result from the many different concepts of income. Use of the concept of cash flows permits the argument, controversy, or analysis concerning the implementation of objectives of accounting to take place on a common ground.

Stating the objectives in terms of the prediction, evaluation, and control of cash flows provides a vehicle for assessing and evaluating all accounting information including income statements, balance sheets, funds statements, and the proper aggregation or disaggregation suitable for such statements. Insurmountable problems related to implementation, communication, and interpretation would result if accounting objectives are defined in terms of accounting income, because methods of assessing and evaluating the worth of different concepts of income are not provided. Thus, no vehicle would exist for making decisions about assets, liabilities, etc.

An example may illustrate this point. Should price level adjusted data be used? If the objective of accounting is to measure income, then the argument can only be joined in terms of whether price level or non-price level adjusted income is superior and whether well-offness should be measured in terms of monetary or "purchasing power" terms. Such an objective, however, would not indicate how this controversy should be resolved.

If, on the other hand, the objective of accounting is to predict, evaluate, and control cash flows, the price level controversy can be resolved, although the solution may differ given varying circumstances.

For instance, accounting income currently describes the relationship between present inflows (revenues) and past and present outflows (cost). This information is useful for evaluating the past and may be useful for predicting future inflow and outflow relationships. It helps answer the question: What inflows will be generated by current and past expenditures for plant and equipment? Should the reporting of past costs be adjusted for price level changes in describing this relationship? The answer should be based on whether adjusted or unadjusted costs are expected to better predict future inflows. This may well depend on whether the past rate of inflation is expected to continue. If it is, then the relationship between current inflows and unadjusted outflows will better predict the future cash inflows in gross dollar terms.

The significance of these dollar inflows will of course be affected by price level changes. The evaluation of the extent of these effects will vary, however, depending on who will realize the cash flows and how they will be utilized. For instance, cash received by stockholders in the form of dividends will probably be spent on "market baskets" different from cash reinvested by corporations. The effect of changes in the general price level will differ to the extent that the usage of cash and preferences for different market baskets differ. This type of assessment is best left to users, since it depends on individual preferences and is necessarily subjective. Yet the method which serves the objective of predicting those cash flows is here capable of objective analysis.

This brief example does not consider aspects of control and evaluation. It helps to illustrate, however, how a controversy like price level adjustments is capable of objective analysis using an objectives framework which relates to cash flows.